

Dariusz Urban PhD
(University of Łódź)

Chapter 6

The Political Implications of Norway's Sovereign Wealth Fund investments in Eastern and Central Europe

Privatization as a core government policy is not only well documented in economic and political literature, but has also been a key component of the transformation process in many countries, which have been changing their economic format from one that is centrally planned to one that is market oriented. Moreover, looking at the large number of developing countries during the last decades we can observe a massive retreat process of states from many areas previously regarded *a priori* as state-owned and state-regulated. Privatization, along with deregulations in many sectors, has been the first answer and the main antidote given by leading global financial institutions to developing economies experiencing budget, financial or economic difficulties (Urban 2015).

However, looking at the global picture as a whole, we can find evidence that over the 2001–2012 period governments acquired more assets through stock purchases than they sold through share issue privatizations and direct sales. The key factor that seems to explain these obvious contradictions is that the government purchases of equity have recently been conducted mostly by state entities acting as investors rather than owners. Much of this state investment was channeled through special investment vehicles – sovereign wealth funds (SWFs), and the vast bulk of stock purchases have been cross border transactions (Bortolotti, Fotak, Megginson 2014).

Given the fact that according to Keynes international capital allocation is always politically motivated, questions arise to whether and to what extent this is true for Government Pension Fund Global (GPF), a sovereign wealth fund operating from Norway. The main goal of this chapter is to analyze investment policy of this state-controlled entity and provide the picture of its portfolio investment in Eastern and Central Europe Countries. For this purpose, the remainder of the chapter is organized in the following manner: in the next part facts and figures about the fund are presented, then the investment policy of the fund is described, after that the holdings of GPF in Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia are analyzed, and finally the political implications of these investments are discussed with particular emphasis on the issue of risks. The chapter ends with conclusions.

6.1. Government Pension Fund Global – facts and figures

The rise and growth of the Norwegian sovereign wealth fund is strongly associated with the exploitation of petroleum resources in the North Sea. Petroleum was discovered there in 1969 and oil production started soon thereafter in 1971. Throughout an almost two decade-long period, a sizeable income from the exploitation of this resource had accumulated and in response thereto, Norway's Parliament passed the Government Petroleum Fund Law. As a result, to support the long-term management of the petroleum revenues the Petroleum Fund was established and since its inception the fund has been a tool of fiscal policy. At the beginning the fund did not operate as an independent entity but constituted a department of the government apparatus, managed by the Norwegian Central Bank (Baker 2009, p. 132).

In 1996 the fund received the first capital transfer from the Ministry of Finance (NOK 46 billion), which was invested in the same way as foreign exchange reserves held by the Norwegian central bank. In the following year the decision was made to diversify the portfolio and invest 40% of the assets in equities instead of holding solely government bonds. In 1998, when the total value of the fund was NOK 172 billion, Norges Bank Investment Management was set up to manage the fund on behalf of the Ministry of Finance. Two years later, five emerging markets were added to the fund's benchmark equity index; by that time the value of the fund was calculated to be NOK 386 billion. In 2002 the fund started investing in corporate and securitized bonds. In 2004 with the fund's value amounted to over NOK 1 billion, the ethical guidelines for the fund were established. The Government Petroleum Fund changed its name to Government Pension Fund Global (GPFG) in 2006. In the next year the Ministry of Finance decided to increase the fund's share of equity investment from 40% to 60% and also to add small-cap companies to the benchmark portfolio. In 2008 real estate was included in the fund's investment universe, with a maximum share of 5% of total assets. By that year the total value of the fund was NOK 2.275 billion and the reference equity index of the fund included all emerging markets. In 2009 the fund's share of equity in its asset portfolio reached 60% and the fund's ethical guidelines were evaluated. By 2010 a mandate to the investment policy of the fund was introduced to invest as much as 5% of the fund in real estate through a corresponding reduction

in the fixed-income holdings. In 2012 the Ministry of Finance announced a plan to gradually reduce the share of European holdings to 40% of the fund and increase its investments in emerging markets up to 10% (<http://www.nbim.no/en/the-fund/history/> [accessed: 3.09.2015]; Canner and Green 2010).

Nowadays, GPFG is the single largest sovereign wealth fund with USD 882 billion worth of assets under management (<http://www.swfinstitute.org/sovereign-wealth-fund-rankings/> [accessed: 3.09.2015]). At the end of 2014 GPFG's portfolio consisted of 9124 equity investments, accounting for 62.3% of the portfolio 4,256 fixed-income investments (36.5%) and real investment accounting for 2.2% of the portfolio (<http://www.nbim.no/en/the-fund/holdings/> [accessed: 3.09.2015]). As regard to geographical location of the investments (see Figure 1) 39.9% take place in Europe, 38% in North America and 15.5% in Asia.

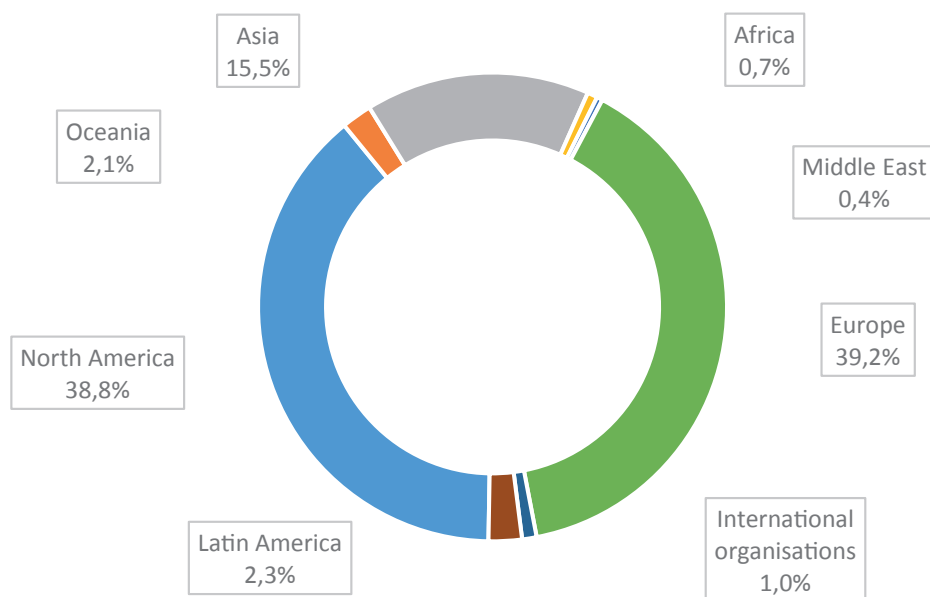


Figure 6.1. Government Pension Fund Global investments by region at the end of 2014

Source: <http://www.nbim.no/en/the-fund/holdings/> [accessed: 3.09.2015].

The fund's annual return ranges from -23.32% to +25.62%, with a 5.9% annualized return since 1998, 6.12% in the last 10 years and 6.92% in the last 12 months (Norges Bank Investment Management, Government Pension Fund

Global Quarterly Report 2015, p. 15). GPFG is a commodity-based sovereign wealth fund with a high level of transparency (10 points in the Linaburg-Maduell Transparency Index – <http://www.swfinstitute.org/sovereign-wealth-fund-rankings/> [accessed: 4.09.2015]).

Besides being the tool for the transfer of the country's wealth for future generations, GPFG insulates the domestic economy from the resource curse, known as the "Dutch disease." The experiences of other countries have shown that the sudden inflow of capital to the economy can rapidly inflate domestic prices and the exchange rate, decrease international competitiveness of the economy and result in de-industrialization (Chambers et al. 2012). Due to capital allocation on foreign markets via the use of the special investment vehicles that are SWFs, governments can improve resource allocation (Gieve 2008, p. 199) and for economies having a surplus of foreign exchange inflow, investing through SWFs gives an opportunity to sterilize this capital, avoid price bubbles and high inflation (Heyward 2008, p. 21). Another economic benefit that GPFG offers is that it helps to reduce the opportunity cost of reserve holdings due to greater portfolio diversification of reserve-assets and reduce the volatility driven by changes in commodity export prices (IMF 2008b, p. 4).

Holding over 1% of the total shares from different regional markets all around the world, GPFG is a leading example of a universal owner (Kiernan 2007; Gjessing, Syse 2007). The universal owner hypothesis states that although a large, long-term investor with diverse investment holdings can initially benefit from a company externalizing cost, the investor might ultimately experience a reduction in overall return due to these externalities adversely affecting returns from other assets. Thus, universal owners have an incentive to reduce negative externalities created by companies from their portfolios, such as pollution emission, corruption and increase positive externalities such as sound corporate governance and good human capital practices across their investment portfolios (Hawley, Williams 2000). For universal owners, overall economic performance will have an influence on the future value of their holdings more than the performance of individual companies or sectors, suggesting that universal owners will support the goal of sustainable growth and well-functioning financial markets. Consequently, a universal owner will view its goals holistically and seek ways to reduce externalities that produce economy-wide efficiency losses (Urwin 2011, p. 26; Nagell 2011, p. 81).

Summing up, GPFG is the largest SWF as well as important institutional investor in global financial markets. But is not the size of the fund that prompts the attentions; it is the investment policy of the fund. Generally speaking, the fund is allowed to invest in targeted companies only if they meet certain corporate governance, social and environmental criteria. Clark and Monk (2010) argue that GPFG has been at the forefront of ethical and socially responsible investment initiatives. As a result, the fund appears to have become an expression of Norwegian commitment to global justice.

6.2. The investment policy of the fund

The investment policy of GPFG has been evolving along with the growth of assets under its management. In 2004 Ethical Guidelines of investment were adopted. The premises for the Ethical Guidelines were two ethical obligations pointed out by the Graver Committee and then discussed and debated by the Norwegian Parliament. The first of them was the obligation to ensure financial returns so that future generations will benefit from the oil wealth, contingent on sustainable development. The second was to respect fundamental rights for those who are affected by the companies in which GPFG invests (Halvorsen 2011, p. 3). Thus, on the one hand it seems to be an expression of the belief that besides intergenerational justice, a sovereign wealth fund should contribute to the implementation of universally accepted values and norms (Reiche 2010, p. 3570).

On the other hand, given the fact that “nothing is external to a global shareowner” (Monks 2001, p. 105) the acceptance of ethical restrictions on investment occurs as a natural consequence of the awareness that arises regarding the role of externalities in portfolio management. The large equity positions, usually held in the form of minor ownership stakes across hundreds and thousands of companies scattered across the globe means that portfolios of such universal investors are exposed to costs linked to negative externalities. For example, a portfolio holding causing excessive greenhouse gases, overusing water and making unsustainable use of natural resources may affect the ability of another company held in the portfolio to operate profitably. Consequently, it undermines the long term risk adjusted return of the universal owner. Thus, ethical guidelines are the tool that socially responsible investors use to actively engage with corporations in order to minimize negative externalities (Létourneau 2013).

GPFG's asset holdings are mainly invested in accordance with a benchmark index determined by the Norwegian Ministry of Finance. This is a list that shows how much capital should initially be placed in each individual security the fund invests in. The benchmark index consists of 60% equities and 40% fixed income, however, gradually 5% of the assets will be invested in real estate. Norges Bank, delegated by the Ministry of Finance to manage the fund, is permitted to deviate slightly, within limits, from this list (Norwegian Ministry of Finance 2010, p. 8).

As a responsible investor GPFG is meant to:

- promote good corporate governance and greater awareness of social and environmental issues among companies in which it has holdings;
- help companies in its portfolio to respect fundamental ethical norms;
- promote sustainable development in an economic, social and environmental sense;
- promote good corporate governance as well as organization of financial markets;
- preclude the Fund from having investments that conflict with Norway's obligations under international law;
- avoid investments in companies that are engaged in grossly unethical activities (Norwegian Ministry of Finance 2010, p. 14).

The responsibility for executing the investment policy of the fund is divided among The Ministry of Finance, Norges Bank and Council of Ethics. The first is responsible for establishing underlying principles for the exercise of ownership rights as well as for criteria regarding the exclusion of companies. It also makes the decision whether or not the company should be excluded. The second exercises the ownership rights in individual cases and also reports quarterly on active ownership activities. The last gives advice on the exclusion of companies from the fund's holdings (Norwegian Ministry of Finance 2010, p. 14).

The investment policy of GPFG states the active ownership to safeguard the fund's financial values by contributing to good governance and by striving to achieve higher ethical, social and environmental standards in the companies. Norges Bank's activity is concentrated in certain key areas of significance to the portfolio of the fund. One of them is equal treatment of shareholders, which is especially important since the fund is mostly a small shareholder in many of the companies. Norges Bank also promotes better regulations and better corporate governance for financial markets, providing regular

input of work on new regulations for the financial market of many countries as well as global principles for corporate governance. Another key area of the interest is the protection of children's rights and given the fact that in many companies and markets there is high risk of child labor, Norges Bank promotes the governance structure and reporting system to address this issue. Since the portfolios of the Fund are exposed to the risk of adverse economic effects of climate change, companies from it are expected to have strategies for managing physical and economic effects of climate change. Additionally, it is to set clear targets for reducing greenhouse gas emissions, to explore opportunities to develop new products and services that will help the transition to a low-carbon economy. Another important component of the Fund's investment policy is the exclusion of companies from the portfolio. Most of the instances of exclusion concern companies that produce certain products, such as key components for weapons that violate fundamental humanitarian principles through their normal use (nuclear weapons, cluster munitions, anti-personnel land mines). Individual companies may also be excluded from the Fund if it is determined that they run an unacceptable risk of contributing to grossly unethical activities (Norwegian Ministry of Finance 2010, p. 22–30).

Summing up, GPFPG with globally diversified holdings, is a leading example of an institutional investor with social, governance and environmental components deeply tied with the core values of the investment policy. GPFPG's activities prove the possibility of combining ethical values with financial expectations regarding the rate of return. At the same time, the Fund is a political tool of the state, used to promote the globally underlying values of the Norwegian people. The stream of capital provided to companies as well as to other governments via the purchase of bonds is conditioned by political factors. Such restrictions on investment are communicated directly, leaving no room for suspicions or suppositions.

6.3. GPFPG holdings in Central and Eastern Europe

A lack of data along with low transparency make it almost impossible to perform an investment analysis of most SWFs. Against this background GPFPG is a prominent exception; the Fund provides comprehensive information about its activities, allowing researchers to evaluate the objectives

and performance of the fund. Despite of that empirical research concerning GPFG investment activity in Eastern and Central Europe Countries is very limited in numbers and provides more of a country rather than regional picture of the issue. Due to that fact an analysis of the GPFG's investment activities in these markets is needed.

Table 6.1. Holdings of GPFG in selected Eastern and Central Europe Countries at the end of 2014 (USD)

| Country | Equities | Fixed-income | Total |
|----------------|---------------|---------------|---------------|
| Bulgaria | – | 125,293,517 | 125,293,517 |
| Czech Republic | 83,730,658 | 957,119,917 | 1,040,850,575 |
| Estonia | – | 14,688,058 | 14,688,058 |
| Hungary | 117,137,959 | 399,014,626 | 516,152,585 |
| Latvia | – | 33,524,729 | 33,524,729 |
| Lithuania | 2,690,878 | 94,782,942 | 97,473,820 |
| Poland | 1,163,857,654 | 2,799,211,006 | 3,963,068,660 |
| Romania | 128,717,213 | – | 128,717,213 |
| Slovakia | – | 261,870,110 | 261,870,110 |

Source: <http://www.nbim.no/en/the-fund/holdings/> [accessed: 4.09.2015].

At the end of 2014, GPFG had holdings in the following countries from the Central and Europe region: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia. The portfolio of assets in these countries consists of two categories: equities and fixed-income assets. Table 6.1 presents the basic information regarding the Fund's holdings in this region.

The data suggests that the highest capital allocation from GPFG is taking place in Poland, followed by the Czech Republic and Hungary. At the end of that list there are the Baltic states. In all countries the Fund has investments in fixed-income assets, excluding Romania. The Fund had not invested in equities in Bulgaria, Estonia, Latvia and Slovakia. However, due to the difference in size of the country, a comparison between economies based on this data does not provide the full picture of the issue. Figure 6.2 presents the capital allocations from the Fund normalized by country GDP, as a proxy for the size of the economy.

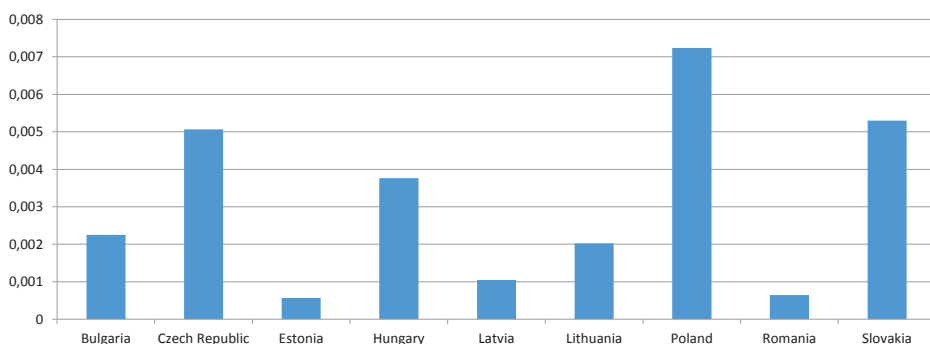


Figure 6.2. Capital allocations of GPFG scaled to country's GDP at the end of 2014 (USD)

Explanation: values on the Y axis are a ratio of capital allocation from the Fund to a country's GDP.

Source: own calculations based on the data from Fund's webpage <http://www.nbim.no/en/the-fund/holdings/> [accessed: 4.09.2015] and World Bank <http://data.worldbank.org/indicator> [accessed: 4.09.2015].

Given the size of the economy measured by country's GDP, a conclusion can be drawn that the Norwegian SWF had invested the most in Poland, with Slovakia taking second place and Czech Republic third. What is worth mentioning is that a relatively low capital inflow from GPFG has been directed to Romania.

As regard portfolio investment, the issue of diversifications versus home bias is often the subject of analysis. According to the portfolio theory, a rational investor should allocate its capital taking into account the share of particular assets in the overall market as well as the share of that market globally. Several authors argue that the behavior of investors is in contradiction with these assumptions. The home-bias hypothesis states that due to the cost of information, similarities in terms of religion, geographical location, etc., investors increase the share of some assets from one market while decreasing the share of the assets from another in their overall portfolio. In order to validate the home-bias preferences of GPFG, using GDP we compared the share of the single economies in the overall GDP of 8 countries with a similar share of capital allocation. The results are presented in Figure 6.3. Two things seem to be clear, Poland is the market flooded by the fund while Romania garners the least interest, given the total portfolio of assets held by GPFG in this group of countries. However, taking the market capitalization of listed companies as a benchmark (Figure 6.4), for these two countries an opposite conclusion can be drawn. In the case of other countries the picture seems to be relatively clear, the capital allocation from the fund is consistent with the share of the country within the group, measured by GDP or market capitalization of listed companies.

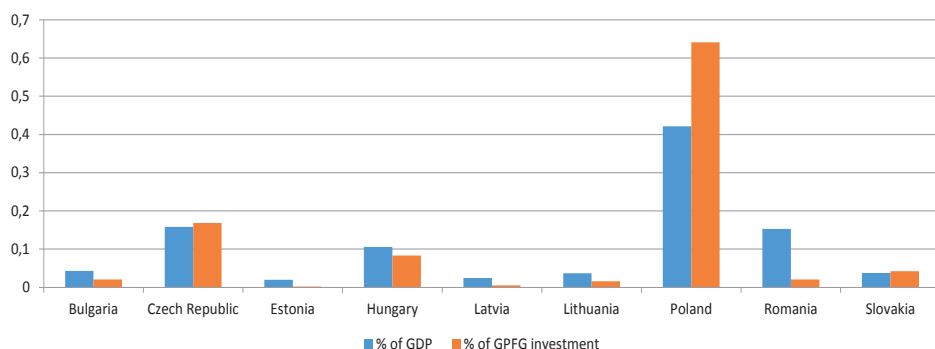


Figure 6.3. Share of a country's GDP versus share of capital allocation from GPF

Source: own calculations based on the data from GPDG's webpage <http://www.nbim.no/en/the-fund/holdings/> [accessed: 4.09.2015] and World Bank <http://data.worldbank.org/indicator> [accessed: 4.09.2015].

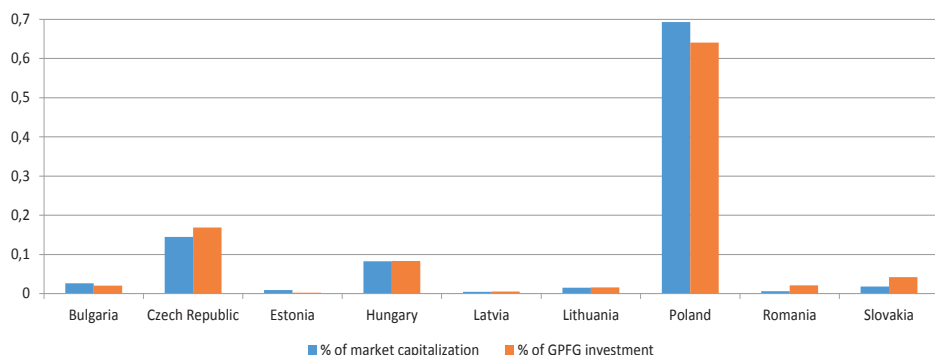


Figure 6.4. Share of market capitalization of listed companies versus share of capital allocation from GPF

Source: own calculations based on the data from GPF's webpage <http://www.nbim.no/en/the-fund/holdings/> [accessed: 4.09.2015] and World Bank <http://data.worldbank.org/indicator> [accessed: 4.09.2015].

GPF's investments in Central and Eastern Europe differ not only in terms of the total value of capital allocated in each economy, but also in terms of the number of portfolio holdings. The fund has 92 equity holdings in Poland, 9 in Romania as well as in Hungary, 4 in the Czech Republic and 1 in Lithuania. The fixed-income investments of the fund consist of national government bond holdings, with the exception of the Czech Republic where there are also 3 holdings in government related companies.

Given the fact that the majority of equity investments in Central and Eastern Europe is allocated in Poland, previous studies have focused on analyzing investment behavior of the Fund in this particular country. Urban (2015) using the financial data from companies listed on the Warsaw Stock Exchange

employed the logit model to analyze the investment attractiveness of companies for the Norwegian sovereign wealth fund. The empirical findings of this research suggest that the likelihood of GPFG investment in a company listed on the Warsaw Stock Exchange is associated with a statistically significant level of total operating revenue, total assets, earnings per share, enterprise value and market capitalization of the firm. These results are to some extent similar to those obtained by Kotter and Lel (2011) suggesting that GPFG prefers investing in large companies. The findings of this study also suggest that not only the growth of earnings per share increases the probability of such investments, but also a company with GPFG as an investor has on average a higher level of earnings per share than companies not targeted for investment by GPFG. As to further research issue the author suggests to search for other motives for investment than financial ones, which is justified because of the relatively low predictive power of the models.

In another study Urban (2015) examined the impact of SWF ownership on the financial performance of firms. Empirical findings of this research based on regression models and financial data of Polish companies listed on the Warsaw Stock Exchange and targeted by the GPFG suggest that SWF ownership has a positive impact on the price to book value of the firm. In case of ROA and ROE as left hand variables the coefficients of GPFG's variable is not statistically significant, however positive. The author points out the need for conducting a comparative study for industry specific issues based on a larger data set and use of panel data.

The current holdings of GPFG on the Warsaw Stock Exchange by industry are presented in Figure 6.5. It suggests that listed companies from the financial sector have the highest share in the overall portfolio holdings of the Fund (38.9%), with industrials taking second place (15.7%) and basic materials third (12.22%). The share of oil & gas companies in the portfolio is 9.38%, consumer goods and consumer services 7.18% and 6.78% respectively. For the remaining industries it is less than 5%. In the case of equity holdings in Romania, 42.99% are listed companies from the financial sector, 32.45% from the oil & gas industry and 24.55% from utilities. The Fund's portfolio in Hungary is overwhelmed by companies from the financial sector with a share of over 90%. GPFG has also shares of 3 listed companies from the Czech Republic (utility, financial, telecommunications) and 1 from Lithuania (industrials).

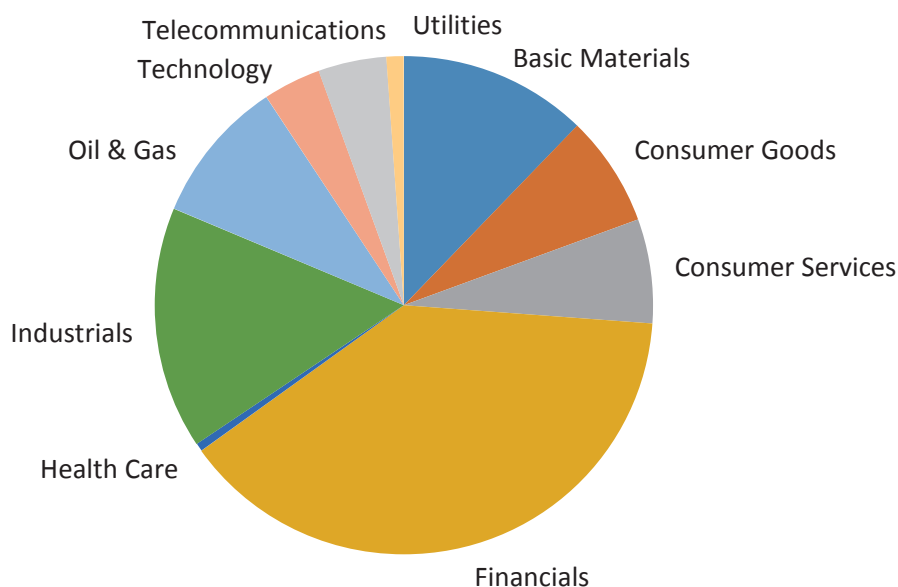


Figure 6.5. Holdings of GPF on the Warsaw Stock Exchange by industry at the end of 2014
Source: own calculations based on the data from GPF's webpage <http://www.nbim.no/en/the-fund/holdings/> [accessed: 4.09.2015].

As for as the average ownership in companies from the Warsaw Stock Exchange is concerned, it ranges from 0.13% in utilities, 0.92% in telecommunications, through to 1.81% in financials and 2.15% in consumer services, and finally 3.18% in industrials and 3.60% in health care. The average ownership in the Polish companies is 2.15%, on the Hungarian stock market it is 0.96% and in Romania 1.23%.

The investment activity of the GPF in Eastern and Central Europe is dominated by holdings in just one market – Poland. This concentration seems to be justified by the size of the economy and the capacity of the Warsaw Stock Exchange. However, to fully understand the investment preferences of the fund in this region, the global holdings of GPF should be analyzed, which, given the size of the portfolio, seems to be a task for further research. In this context comparative analysis of GPF's portfolio holdings from different emerging markets would be an interesting avenue for future research. Further studies should also focus on other than only financial characteristics of firms and take into account environmental, social and governance factors that could possibly determine the capital allocation of the largest SWF and socially responsible investor – Government Pension Fund Global.

6.4. Political implications of GPFG's capital allocation

SWFs, as it was pointed out earlier in this book, are a heterogeneous group of investors, with different objectives, changing over the time. The hybrid nature of these entities implies not only methodological difficulties in defining which state run fund is and which is not a SWF, but also makes it difficult or even impossible to draw conclusions that can be generalized to the entire group. Moreover, the lack of transparency about strategic asset allocation and the absence of a robust model describing it hinders in many cases the analysis on whether SWFs pursue political goals, rather than purely financial objectives (Bertoni, Lugo 2012). Against the majority of funds, GPFG is a unique case. The high transparency of its activities allow one to verify a hypothesis about financial as well as political motives of its investments. In this sub-chapter we address the issue of risk or concerns related to the activity of the Norwegian state-run fund.

Looking at the list of potential treats, bearing in mind the characteristics of GPFG, it is difficult to clearly point out a particular one. As regard to the pursuit of political and economic power objectives via SWFs, it seems to be very limited, probably due to the relatively low purely economic as well as political influence of Norway on other countries from the region and globally. SWFs can be use to support or complement other tools of political influence rather than replace them. Future studies should analyze the relationship between economic and political power of the SWF's host country and the level of political engagement of the funds. Given the fact that GPFG investments are fully transparent and there is no sign of concentration in sensitive industries of the countries, it is unlikely that the activity of this fund will stimulate financial protectionism in countries from the region. Contrary, promoting better regulations and corporate governance for financial markets along with providing regular input of work on new regulations for the financial market of many countries as well as globally, which the fund does, in the author's opinion affects markets in the opposite direction. However, GPFG can have a negative impact on the selected group of companies from the region. The political decision of the Norwegian Parliament to stop investing in coal-industry companies and withdraw the money previously invested in this sector, might affect the value of the shares and valuation of the companies. Due to the fact that the Norwegian fund has relatively low stakes in companies listed on stock exchanges, such

a threat is rather limited. On the other side it is likely that in the future Norway will use its capital transferred to the economy as a bargaining chip to encourage a particular country to reduce its CO₂ emissions. Finally, addressing the issue of a conflict of interests between countries with SWFs and countries in which they invest, it is worth reminding that ethical guidelines for investment preclude capital allocation that conflict Norway's obligation under international as well as a given state's law. As a consequence of that, such risk is relatively low.

To sum up, the abovementioned analysis does not support the hypothesis that the investment activity of GPFG poses a significant and real threat to targeted companies or countries, however, it seems to be clear that the Fund has been used as a political tool. In the case of countries from Eastern and Central Europe, political use of the fund is rather limited, most likely due to the fact that this group of countries share the same canon of values, rules and principles as Norway does.

Conclusions

With USD 882 billion of assets under its management and 2.4% of holdings of total shares of companies in Europe, the Norwegian Government Pension Fund Global proves to be an important institutional investor with possible implications for asset prices. The latest decision of the fund to reduce its holdings in companies engaged in coal mining along with low prices of natural resources might have an influence on company valuations, located not only in Central and Eastern Europe. At the same time this political decision sends a clear signal to the public opinion that deeper and faster action needs to be taken to address the issue of global warming and climate change. Large institutional investors often have sufficient financial as well as political power to become drivers of change; GPFG's investment activity is clear evidence of that. Along with other institutional investors, GPFG can use capital allocation as a tool of political pressure, depending on the economies and companies it allocates capital to. However, without obligations regarding climate change on the global level, the influence of the Fund in this issue is rather limited.

Good corporate governance practices, sensitivity regarding human, social and environmental issues, and the ability to promote the canon of values professed by the Norwegian society are the key characteristics of GPFG, and have been the subject of analysis in this chapter. The growing capital

engagement and high transparency standards give premise for further empirical studies not only about the impact of investments on financial performance of targeted companies but also on the political aspects of capital allocation.

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